$50.00 ANNUALLY
40 Letters Per Year

DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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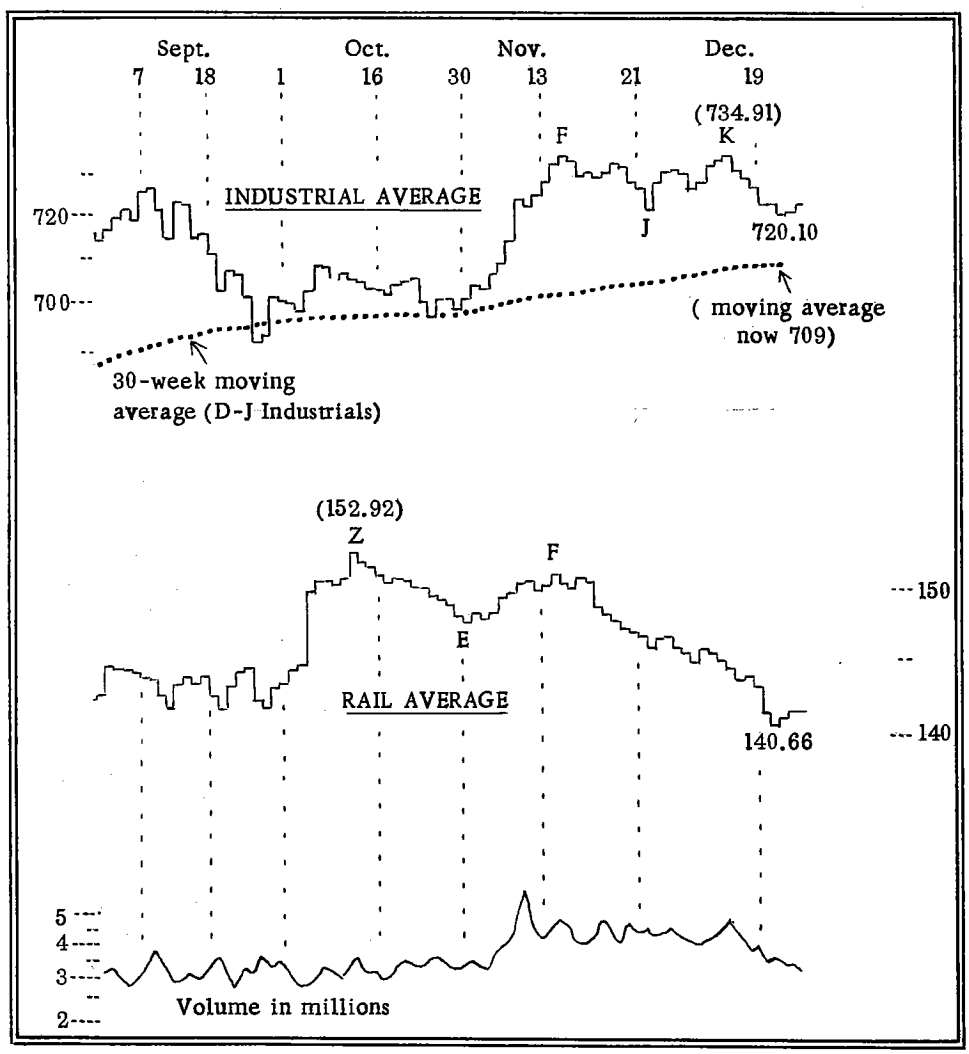
THE MARKET In discussing the technical vs. the fundamental approach, John Magee once used the example of "the lighted pigs". A biologist and a chartist were competing to find out which one could best anticipate the action of three pigs. They were interested, not in why the pigs did certain things, but when and how they did them. The biologist subjected the pigs to a great many intricate psychological and physiological tests. Meanwhile, the chartist did a strange thing. To demonstrate the superiority of his methods, he attached a long pole to the back of each pig, and on the end of each pole he fastened a different colored light. The chartist then seated himself in the branches of a tree from whence he could see only the poles and the lights, but seldom the pigs themselves. For two weeks the chartist drew diagrams (by day and night) of where those lighted poles went. At the end of the two weeks the chartist knew that at 9 A.M. each day the red pole went to the watering trough; he knew that at 11 A.M. the green pole trotted round and round the pen while the yellow pole stood near the gate; he knew that at midnight all three poles moved from the drafty side of the pen to the warm side. In short, the chartist (actually knowing nothing about pigs) had charted in great detail the expected movements of the porkers. The biologist, meanwhile, was bogged down in a mass of information, little of which was of any great value in determining the daily or nightly path of the pigs.

Dow's Theory is actually a body of knowledge which in its barest outline (leaving out values, psychology, etc.), is comparable with the study of the colored lights. For instance, in examining the action of the Averages over a period of sixty-five years, the Dow Theorist has learned, among other things, that the movements of a single Average should never be considered alone. Further, the Dow Theorist has learned that the last trend should be considered to remain in effect until the contrary has been proved.



To apply these simple observations to the current market, the last few Letters drew attention to the persistent (downward) diverging action of the Rails in the face of the rallying efforts of the Industrials. Since the primary and secondary trends were last confirmed as bullish, I had felt (despite the steady Rail divergence) that the market argument should remain weighte in favor of the bulls.

On November 27 Rails broke below their own point E, and a large descending zig-zag was formed in the carrier Average. The Rail penetration also provided one half of a bearish signal (see Letter 164) and cast a measure of doubt over the continuance of the secondary trend. But doubts are one thing and proof is another. Against the pronounced downward pattern in the Rail Average, Industrials (on Dec. 13) rose to an all time high of 734.91. Following this new peak, Industrials abruptly turned down and followed the sinking Rail Average.

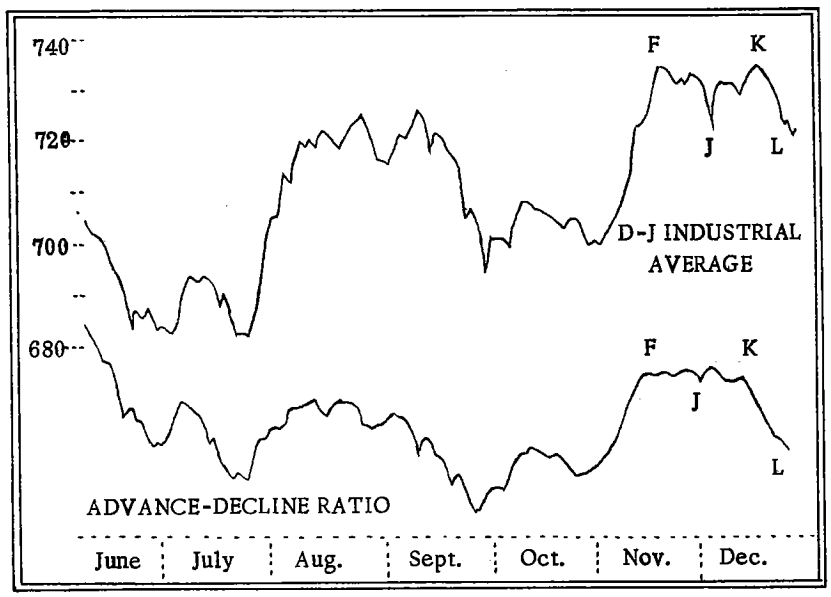
When one Average rises to a bull market high, and that new high is not confirmed by the other Average (as was the case Dec. 13), the situation always contains elements of potential danger. The danger is heightened when a major non-confirmation takes place (as it has) in the face of a barrage of good news and optimistic forecasts.

Letter 165 stated that "the danger signal would be a high volume violation of the J (721.60) level". On December 21 Industrials dropped below 721.60. A few things were notable regarding the penetration: (1) volume (already running at relatively low levels) receded to 3.4 million shares on the penetration. This was equal to the lowest volume since November 1. (2) New lows (see later section in this Letter) held to only 17, a remarkably small number considering that Industrials had broken the entire structure which had been built up since early November.

Occasionally, an important downside level will be violated, and the market seems merely to be probing to find out whether any weakness will be touched off (this occurred last during the July penetration). The clue to weakness (selling pressure) is volume. In the current instance, with volume not showing itself and with new lows refusing to expand, the odds would appear to be pointed in favor of a rally. Best test of the strength of such a rally would be (1) the ability of volume and new highs to expand with higher prices, and (2) the ability of the Rails and the advance-decline ratio to follow the Industrials.

CONCLUSION: The primary trend continues bullish. The secondary price structure has been violated, but so far neither downside volume nor broad weakness has appeared -- for this reason I prefer to label the secondary trend as obscure. However, another downward zig-zag in both Averages would almost certainly mean that the secondary trend had turned bearish. Bulls have found the market to be an exasperating affair during the last month. Until or unless Rails are able to trace a definite upward trend, I believe most trading positions will continue to be unprofitable.

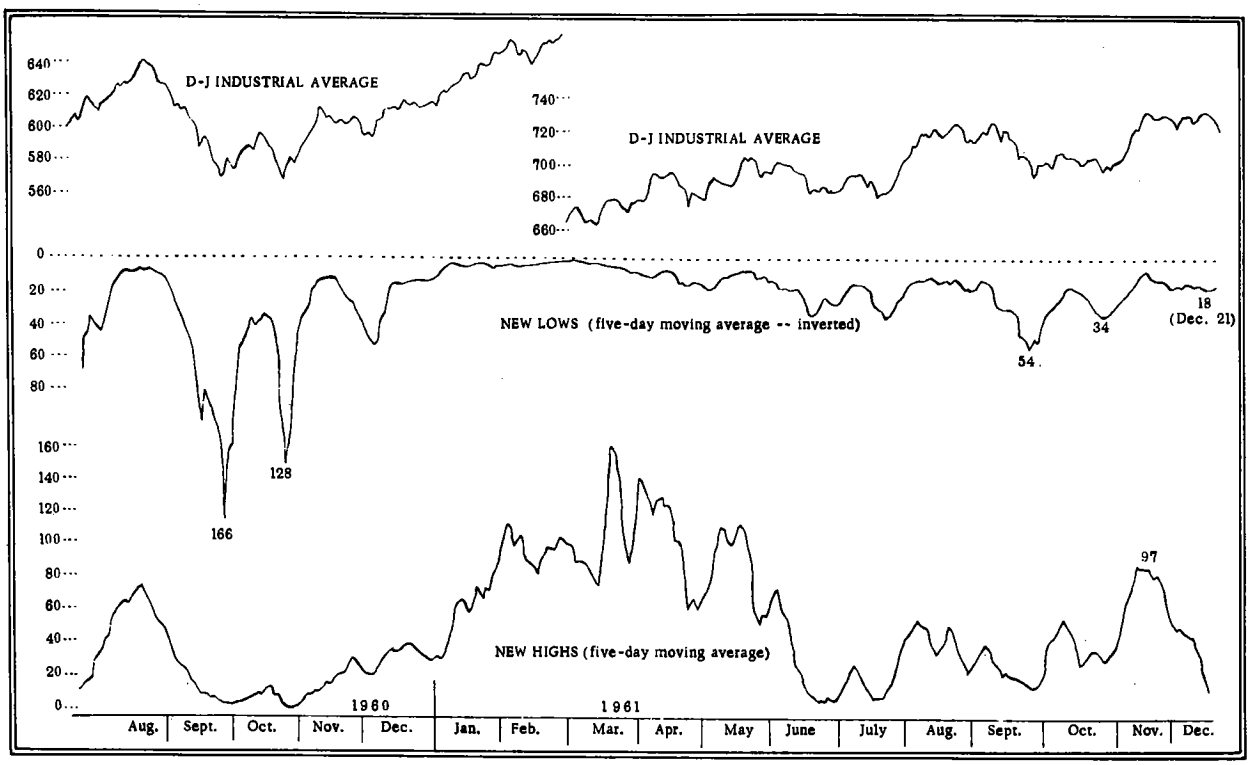
THE ADVANCE-DECLINE RATIO (A-D ratio) shows that the market has lagged well behind the Industrial Average. At point F, both Indicators established highs. A decline to J ensued. On the advance to K, Industrials rose to a new high, but this peak was not confirmed by the A-D ratio. During the K-L decline the A-D ratio broke well below the preceding J level, and on December 21 Industrials confirmed the weakness by dropping fractionally below J (721.60). A new Industrial high now seems well within the realms of possibility, but it would take a tremendous amount of broad market strength before the A-D ratio could confirm. A new Industrial peak, followed by another decline in the A-D ratio below the L level would be bearish and would mark the beginning of real (and dangerous) divergence between the two indicators. In healthy bull movements, the market (A-D ratio) must follow or stay "in gear" with the Industrial Average.



NEW HIGHS AND LOWS The indexes of new highs and new lows, when properly used, provide one of the best measurements of market strength or weakness. I have found three factors to be of importance in utilizing these indexes: (1) The indexes should be constructed in the form of short-term moving averages (in order to smooth out erratic daily performances) -- I use a five-day moving average. (2) Each index should be compared with its own preceding levels in order to obtain the best indication of market strength or weakness (many analysts use a ratio of new highs to new lows, but I have not found this method particularly helpful). (3) On rallies, new highs should expand steadily. However, a drop in new highs will often signal a period of consolidation (not necessarily a reversal as is commonly supposed). During periods of true weakness, not only will new highs drop off, but new lows will expand beyond preceding levels. In other words, a contraction in new highs without a concurrent expansion in new lows does not necessarily imply underlying weakness. The exact reverse of rule 3 applies during periods of decline.

To illustrate, I have included a chart of the five-day moving average of new highs and new lows for the period of August, 1960, to the present. This chart is worth studying in detail.

In September, 1960, the new low index expanded to 166 as the Industrial Average plunged to a low of 569.08. A sharp rally followed. One month later the Industrial Average dropped to an extreme low of 566.05, but note that in October the new low index "bottomed out" at the considerably higher level of 128. This dramatic October contraction in new lows was one of the first indications of an impending upward reversal (the market, as measured by new lows, was refusing to confirm the weakness of the Industrial Average).



A major upturn followed almost immediately, and in November the new high index began climbing while the new low index steadily contracted. (During March of each year the high-low indexes are begun anew by the Stock Exchange -- thus, the sharp jump in new highs in March of 1961). However, from the March-April peaks of 140-160 new highs, the new high index began to fall away. Moreover, in June the new low index provided bearish indications by dropping below preceding levels. All of this corresponded with a downturn in the advance-decline ratio and a generally "mixed" market.

In June and July, true to the warning of the new low index, the Industrial Average and the great majority of stocks went into a pronounced downtrend. A final low of 54 was recorded by the new low index in late September. Note, however, the subsequent superior action of the new low index one month later in October. Note also, the expansion of the new high index to a peak of 97 in mid-November. Following the mid-November performance, the new high index dropped rapidly (in the face of an all-time high on the Industrial Average).

To bring matters to the present, despite the current decline in new highs, the two indexes will not be signaling definite trouble unless new lows expand first beyond the October total of 34 and then beyond the September total of 54. Conversely, in the present situation a persistent refusal by the new low index to expand beyond the October total of 34 should be taken as an indication of underlying strength.

CORRECTION: Paragraph 1, page 3, Letter 165 should read -- "Two weeks after August 28 (on September 7), the market did hit a temporary peak of 726.53. From that high, Industrials broke 35 points to a September low of 691.86. Then, as if to make a liar of the C.I., the market again rallied to another all-time high of 734.34 on November 15 -- this despite the fact that the C.I. had never reversed its steady downtrend following the April 28 peak."

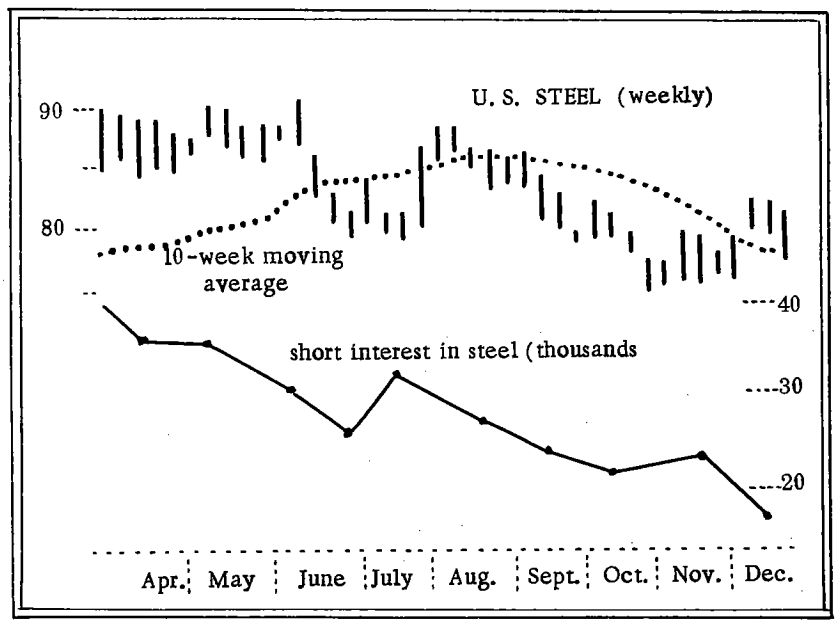
SUNDRY COMMENT The following is from Standard & Poor's "Annual Forecast". Those who were in the market a generation ago may recognize a familiar ring: "We believe that historically high appraisals must now be accepted. They are the product of a broadening base of stock ownership and the tendency, on the part of both the professional and the general investor, to seek long-term values. This does not mean an unending rise in valuations, but a new 16-20 plateau of price-earnings ratios, contrasted with the old norm of 10-13".

STOCKS Of 55 "key" stocks which are watched with particular interest at this office, 25 are now holding above their 10-week moving average. This is a sharp drop of 8 since the last Letter, and it again puts our bullish percentage below 50%.

A good deal has been written about the recent weakness in the "defensive issues", issues which have up to now been extremely strong (utilities, foods, retail). At the same time, many analysts claim to see signs of increasing strength in the cyclical issues (these issues have, for the most part, been laggards during the advance since October, 1960). Two of the cyclical issues which qualify as "backbone of the economy" stocks are U. S. Steel and Anaconda Copper. It is difficult to envision a true cyclical upturn in the economy without prior or concurrent strength in these two major stocks. In view of this, it is worth analyzing Steel and Anaconda in detail.

Anaconda (A) broke above its moving average (M. A.) in January, 1961, then rose almost 20 points to a high of 65. The first hint of trouble (see Letter 158) came when the trendline (marked A on chart) was violated in June. In July, the stock dropped below its M. A., thus providing conclusive proof of weakness. Recently, A has shown the first signs of impending strength. In early December the stock rose slightly above its M. A. and also above the long descending trendline marked B. The stock is now holding well above its October low of 44. If it can stay above its current M. A. of 48 7/8, then climb above the November peak of 52, I will list this stock as definitely having turned bullish. Small speculative purchases might be warranted in the 50-51 area with additional purchases warranted if the stock rises to 53.

U. S. Steel (X) dropped from the 90's in April-June to a low of 75 1/4 in October. During that time the technical position of the stock deteriorated due to the constant shrinkage of the short position. X has recently hurdled its M. A. (now 78 1/2), but the stock has shown little real strength. This is particularly interesting in view of the current high rate of steel production and the distinct possibility of a steel strike in 1962. A rise to 84 would provide a definitely bullish pattern for X, since this would take the stock above its December peak. X is now trading above its M. A. and is probably worth limited speculative commitments at this time. Positions in X could be increased if the stock rises above 84.



LATE NOTE This morning (Wednesday, December 27, 12 P.M. New York time) Industrials jumped over 4 points while Rails rose almost a point. A continuation of this rally could easily put Industrials at a new all-time high with Rails and the A-D ratio unable to confirm. Unless the latter two indicators evince a real ability to rise with the Industrials, I would be inclined to check my bullishness, regardless of a new high on the Industrial Average.

Written Wednesday, December 27, 1 P.M. New York time.